Part II

Background and evidence

3 The companies and the merger situation

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National Express Group PLC

History and origins

3.1. The origins of NEG lie in the creation in 1968 of the state-owned NBC, which effected the integration of a large number of both state- and privately-owned bus and coach operators which had previously operated independently of one another. This was the result of a Government initiative to create a more integrated national public passenger transport system.

3.2. The National brand name was introduced in 1972 to cover the scheduled long-distance coach services operated by the constituent members of NBC. These services first used the title of `National Express' in 1974.

3.3. The Transport Act 1980 took the first step towards the deregulation of the bus and coach industry, providing for the removal of road service licences for long-distance coach operations (being defined as routes on which no passenger travelled less than 30 miles, measured in a straight line). In the face of the new competition which deregulation created, the frequency and general competitiveness of National Express services were significantly enhanced. A better level of service emerged on certain routes, involving higher-specification coaches, with more on-board facilities, and more direct routes, and in 1981 National Express adopted the brand name Rapide and applied it to all such premium operations.

3.4. Following the deregulation of local bus services outside London as a result of the Transport Act 1985, the Government elected to sell NBC to the private sector, not as a single entity but piecemeal. As a consequence a large number of management buy-outs followed, and in 1988 the then management and employees instigated the buy-out of National Express Limited, the long-distance coach activity of NBC.

3.5. Operating under the new name of National Express Holdings Limited (NEHL), the company had as its core business the operation of scheduled long-distance coach services. But alongside this activity the new management began to diversify, making a number of acquisitions, notably the local bus operator Crosville Wales, the coach operator Amberline and the coach operation that later became Express Travel.

3.6. The financing costs associated with these acquisitions, coupled with the poor trading performance of all of them except Express Travel, and the impact of the recession on the core businesses, resulted in a deterioration of the group's financial position from early 1990. The culmination of these circumstances was the acquisition on 23 July 1991 of NEHL by a new management team with the backing of a number of development and venture capital investors.

3.7. The new management team led by Mr Ray McEnhill, who was to remain the Chief Executive of NEG until his retirement in August 1996, began to refocus the group on its core activities, selling Crosville Wales and Amberline and divesting interests in a number of joint ventures.

3.8. On 11 October 1991 NEHL changed its name to National Express Group Limited. Later in the same month it purchased Speedlink Airport Services Limited, an operator of coach services primarily between Heathrow and Gatwick, from the Drawlane Transport Group.

3.9. In December 1992, in order to develop its operations further and to create an improved capital structure, the company arranged an offer and placing of some 27.8 million ordinary shares of 5p each at £1.65 per share. At the same time application was made for admission to the Official List of the London Stock Exchange. The offer and placing comprised the issue of 15.5 million new ordinary shares and the sale of 12.3 million ordinary shares by existing shareholders. The issue of 15.5 million new ordinary shares raised some £23.9 million (after expenses). NEG used the finance to redeem its 10 per cent cumulative preference share capital and to institute a programme of group expansion and modernization of the coach network and to introduce new facilities to meet additional requirements highlighted by market research.

Corporate strategy

3.10. NEG told us that its strategy at the time of the management buy-in in 1991 was to:

(a) refocus the business of the group;

(b) improve the efficiency, quality and level of service within the group's existing operations;

(c) look at developing new products within the existing operations; and

(d) develop organically and by the acquisition of new businesses related to the existing operations.

3.11. Over the past four to five years NEG has diversified its activities away from express coaching with acquisitions of airports, bus operations and now rail franchises. NEG sees itself as a broadly-based passenger transport group with particular competencies in mass passenger transport and in the transition from public to private sector ownership of passenger transport operators. It intends to pursue further development both at home and overseas in its now enlarged core activities.

3.12. NEG's strategy for UK domestic rail operations is to develop a portfolio in the rail sector, balancing commuter, rural and InterCity routes in different regions of the UK, to spread the commercial risk of demand variances. It intends to bid for the remaining rail franchises as they become available until it has acquired a suitable portfolio.

Activities and development since flotation

3.13. Since flotation NEG has continued its expansion and development as follows:

(a) In May 1993 NEG acquired Scottish Citylink Coaches[1] for £5.6 million.

(b) In July 1993 NEG acquired Eurolines (Nederland) BV for £2.2 million, its first continental European acquisition and a member of the Eurolines Organisation of 40 coach operators co-ordinating scheduled coach services between European countries. NEG had for some time prior to this owned Eurolines (UK), the sole UK member of the Eurolines Organisation.

(c) In August 1993 NEG acquired EMIA from the then four local authority shareholders for £28.3 million.

(d) In April 1995 NEG acquired Bournemouth International Airport for £7.4 million.

(e) In April 1995 NEG acquired West Midlands Travel (WMT), a major provider of bus services in the West Midlands and previously the municipal bus operation of the West Midlands Passenger Transport Executive, for £248.3 million.

(f) In February 1996 L&CR, a consortium of which NEG is a founder member with a 17 per cent share, was awarded the contract to build and operate the Channel Tunnel Rail Link and to operate Eurostar services.

(g) In April 1996 NEG was awarded the franchises to operate the Gatwick Express and MML passenger rail services.

Current activities

3.14. Thus NEG now comprises four main businesses: express coaches, airports, urban buses and railways.

Express coaches

3.15. NEG's express coach business is divided into five separate operations:

(a) NEL;

(b) Scottish Citylink;

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[1]Reported on in the MMC's Saltire report: op cit.

(c) Eurolines;

(d) Polski Express; and

(e) Speedlink.

3.16. NEL organizes, controls and markets a network of over 200 routes serving over 1,100 destinations daily. NEL is discussed further in paragraphs 3.33 to 3.50.

3.17. Scottish Citylink operates express coach services in Scotland.

3.18. NEL and Scottish Citylink together comprise NEG's non-airport UK express coach operations.

3.19. Eurolines (UK) Limited and Eurolines (Nederland) BV are major partners in the Eurolines International long-distance coach organization which provides services to 470 towns and cities throughout Western and Central Europe.

3.20. Polski Express has been set up by NEG to provide long-distance scheduled coach services within Poland.

3.21. Speedlink has a range of airport-related services with dedicated ticket offices and lounges within the terminals at Heathrow, Gatwick and Stansted Airports. It is also responsible for services under the Jetlink, Gatwick Direct and Flightline names. Speedlink provides express coach services between Heathrow and Gatwick and from south-east centres of population and certain railway stations to Heathrow, Gatwick and Stansted Airports.

Airports

3.22. EMIA is the fourth-largest regional airport (ie excluding the three main London airports) in England in terms of passengers handled. EMIA is situated on an 850 acre site at the junction of the M1 and M42 extension and close to the M6. The airport primarily serves the cities of Derby, Nottingham, Leicester and Sheffield. In addition, residents of Birmingham, Stoke-on-Trent, Northampton, Lincoln and Peterborough are within the airport's catchment area with an approximate total of 12 million people living within 90 minutes' travel of the airport.

3.23. Bournemouth International Airport is small in terms of passenger numbers but the site and catchment area are large. In order to develop traffic at the airport, NEG has invested £2 million in a runway extension which now enables the airport to handle fully-loaded long-haul aircraft.

Urban buses

3.24. WMT operates the largest single area bus fleet in Great Britain with over 1,700 public service vehicles on 114 million scheduled annual vehicle kilometres and about 5,000 employees. WMT is a major provider of local bus services in the West Midlands conurbation, serving Birmingham, Coventry, Dudley, Sandwell, Solihull, Walsall and Wolverhampton-carrying 325 million passengers a year in this densely populated urban area of some 2.5 million people.

Railways

3.25. NEG's rail interests currently comprise:

(a) *MML:* On 28 April 1996 NEG was awarded a ten-year franchise to operate passenger rail services on the Midland Main Line (described in paragraphs 3.51 to 3.66).

(b) *Gatwick Express:* On 28 April 1996 NEG was awarded a 15-year franchise to operate the Gatwick Express services between London Victoria and Gatwick.

(c) *L&CR:* NEG holds a 17 per cent share in L&CR.

Structure

3.26. NEG acts as a holding company, with each subsidiary having a Board comprising directors of NEG and executive directors responsible for its financial and operational performance and for managing its own staff and activities. NEG told us that it operates on a highly decentralized basis with a very flat management structure at group level. The corporate structure of the group is set out in Appendix 3.1.

Financial performance

3.27. NEG prepares its accounts to 31 December each year. The financial performance of NEG over the last five years is summarized in Table 3.1.

TABLE 3.1 **NEG: financial summary, 1991 to 1995**

£'000

	Years ended 31 December				
	*1991**	*1992*	*1993*	*1994*	*1995*
Turnover	124,628	120,628	139,047	170,009	317,744
Operating profit	5,136	6,314	9,252	16,278	44,044
Profit/(loss) on ordinary activities (before interest and taxation)	(353)	6,909	9,488	16,278	44,044
Profit/(loss) on ordinary activities before taxation	(1,242)	6,818	9,305	15,236	41,538
Net operating assets/(liabilities)†	(5,145)	(3,309)	27,652	26,244	99,614
Average net operating assets/ (liabilities)	(5,145)‡	(4,227)	12,171	26,948	62,929
					per cent
Operating profit as a percentage of turnover	4.12	5.23	6.65	9.57	13.86
Profit on ordinary activities (before interest and taxation) as a percentage of turnover	-	5.73	6.82	9.57	13.86
Profit on ordinary activities (before interest and taxation) as a percentage of average net operating assets	-	-	77.96	60.41	69.99

Source: NEG.

*Published accounts for 1991 covered the 23-week period ended 31 December 1991. Full year figures for 1991, shown above, taken from the Listing Particulars (published in connection with NEG's listing on the London Stock Exchange in December 1992).
†Comprises tangible fixed assets (excluding investments) and other net assets (excluding proposed dividends and cash/borrowings).
‡Closing net operating assets.

Further information on NEG's balance sheet and profit and loss account is given in Appendix 3.2, Tables 1 and 2.

3.28. An analysis of turnover and operating profit for 1991 to 1995 by operation is set out in Table 3.2. During this period NEG diversified from express coaching to other activities including airport management and bus operations. The increase in turnover and operating profit over the period from 1991 to 1995 is mainly owing to the acquisitions (listed in paragraph 3.13). Table 3.2 shows that airports and bus operations have proved to be more profitable than NEG's original express coaching business.

TABLE 3.2 **NEG: analysis of turnover and operating profit, 1991 to 1995**

£'000

	Years ended 31 December				
	*1991**	*1992*	*1993*	*1994*	*1995*
Turnover					
Express coaching	113,824	117,058	131,005	150,493	157,919
Airports	-	-	7,722	19,516	26,071
Buses	-	-	-	-	133,754
Discontinued activities	10,804	3,570	320	-	-
	124,628	120,628	139,047	170,009	317,744
Operating profit/(loss)					
Express coaching	5,573	5,691	7,060	9,857	9,685
Airports	-	-	2,152	6,421	9,614
Buses	-	-	-	-	24,745
Discontinued activities	(437)	623	40	-	-
	5,136	6,314	9,252	16,278	44,044
					per cent
Operating profit as a percentage of turnover					
Express coaching	4.9	4.9	5.4	6.5	6.1
Airports	-	-	27.9	32.9	36.9
Buses	-	-	-	-	18.5

Source: NEG.

*Published accounts for 1991 covered the 23-week period ended 31 December 1991. Full year figures for 1991, shown above, taken from the Listing Particulars (published in connection with NEG's listing on the London Stock Exchange in December 1992).

3.29. The percentage of total operating profit generated by each operation for the last five years is set out in Table 3.3. While the profitability of express coaching (measured as the percentage of operating profit to turnover) has remained relatively static, its contribution to group operating profits has been diluted in recent years with NEG's diversification into airports and buses.

TABLE 3.3 **NEG: percentage of total operating profit generated by express coaching, airports and buses, 1991 to 1995**

per cent

	Years ended 31 December				
	1991	*1992*	*1993*	*1994*	*1995*
Express coaching	100	100	76	61	22
Airports	-	-	24	39	22
Buses	-	-	-	-	56
	100	100	100	100	100

Source: NEG.

3.30. Within express coaching there are five businesses: NEL and Scottish Citylink (together referred to as UK Express Coach Travel[1]), Eurolines, Polski Express and Airport Coach Services. NEL provides express coach services in England and Wales, and Scottish Citylink provides similar services in Scotland.

3.31. Table 3.4 analyses the turnover and operating profit for express coaching from 1991 to 1995.

[1]Up to May 1993 UK Express Coach Travel comprised NEL and Express Travel Limited. In May 1993 Express Travel Limited was sold. In the same month Scottish Citylink was acquired and since then UK Express Coach Travel has comprised NEL and Scottish Citylink.

TABLE 3.4 **NEG: analysis of turnover and operating profit for express coaching, 1991 to 1995**

					£'000
	Years ended 31 December				
	*1991**	*1992*	*1993*	*1994*	*1995*
Turnover					
UK Express Coach Travel†	99,109	95,094	99,784	108,985	[‡
Eurolines	13,233	15,153	23,018	32,429	]
Polski Express	-	-	-	123	1,332
Airport Coach Services	1,482	6,811	8,203	8,956	12,761
	113,824	117,058	131,005	150,493	157,919
Operating profit/(loss)					
UK Express Coach Travel†	4,641	3,948	4,852	7,631	[‡
Eurolines	979	1,100	1,485	2,041	]
Polski Express	-	-	-	(504)	(967)
Airport Coach Services	(47)	643	723	689	1,066
	5,573	5,691	7,060	9,857	9,685
Operating profit/(loss) as a percentage of turnover					*per cent*
UK Express Coach Travel†	4.7	4.2	4.9	7.0	6.4
Eurolines	7.4	7.3	6.5	6.3	7.4
Polski Express	-	-	-	(409.7)	(72.6)
Airport Coach Services	(3.2)	9.4	8.8	7.7	8.4
Total	4.9	4.9	5.4	6.5	6.1

Source: NEG.

*Published accounts for 1991 covered the 23-week period ended 31 December 1991. Full year figures for 1991, shown above, taken from the Listing Particulars (published in connection with NEG's listing on the London Stock Exchange in December 1992).

†UK Express Coach Travel comprises NEL, Express Travel Limited (up to May 1993 when this company was sold) and Scottish Citylink (from its acquisition by NEG in May 1993).

3.32. On 10 September 1996 NEG released its unaudited interim results for the six months ended 30 June 1996. These show an increase in turnover and operating profit, of 79.4 and 147.6 per cent respectively, compared with the corresponding prior year period. Table 3.5 analyses turnover and operating profit by activity for the six months ended 30 June 1995, 31 December 1995 and 30 June 1996. NEG told us that express coaching is a seasonal business with the second half of the year traditionally generating higher revenues and profits than in the first half of the year.

TABLE 3.5 **NEG: turnover and operating profit, six months ended 30 June 1995, 31 December 1995 and 30 June 1996**

	Six months to 6.6.95		*Six months to 31.12.95*		*Six months to 30.6.96*	
	£'000	*%*	*£'000*	*%*	*£'000*	*%*
Turnover						
Express coaching	68,063	59.3	89,856	44.3	73,201	35.6
Airports	11,028	9.6	15,043	7.4	12,857	6.2
Buses	35,621*	31.1	98,133	48.3	92,054	44.7
Trains	-	-	-	-	27,707	13.5
	114,712	100.0	203,032	100.0	205,819	100.0
Operating profit/(loss)						
Express coaching	(83)	(0.9)	9,768	27.8	61	0.3
Airports	2,761	31.1	6,853	19.5	3,041	13.8
Buses	6,203	69.8	18,542	52.7	18,488	84.1
Trains	-	-	-	-	401	1.8
	8,881	100.0	35,163	100.0	21,991	100.0

Source: NEG.

*Represents 2½ months' trading for WMT acquired in April 1995.

National Express Limited

3.33. NEL, a wholly-owned subsidiary of NEG, operates a national network of long-distance coach services. NEL is based in Birmingham. It employs approximately 650 staff of whom 165 are based in its head office and 485 at local sub-offices or working as customer care staff on coach stations.

NEL's functions

3.34. NEL is not itself an operator of coaches. Its business involves organizing, pricing, marketing, selling and co-ordinating a network of scheduled coach services linking over 1,100 locations throughout Great Britain over approximately 200 routes. The vehicles NEL uses to operate its services are entirely contracted in from coach operators based throughout Great Britain.

3.35. NEL offers its customers a nation-wide network of scheduled coach services which operate under the National Express name and livery. NEL bears all commercial risks connected with the operation of these services. A more detailed description of NEL's operations is set out in paragraphs 3.41 to 3.46.

3.36. NEL is responsible for:

(a) establishing the timetable for its services, including creation of journey opportunities by means of co-ordinated interchange;

(b) establishing fare levels and structures for each of its services. Details of the fares are set out in the timetable issued to sales agents. Additional special offers may also be made available from time to time;

(c) monitoring reservation levels to ensure that at peak times, where demand exceeds the capacity of a single coach, additional coaches are made available;

(d) producing and distributing promotional material for its services including point-of-sale information which is distributed to tourist offices, libraries, hotels and sales agents. NEL told us that in 1996 it expects to spend about £2 million on advertising its coach services in the national and local press;

(e) providing passenger assistance and information at coach stations through NEL employees who supervise the arrival and departure of coaches;

(f) operating a passenger complaints procedure which is used to monitor quality, remedy shortcomings and improve service standards generally;

(g) monitoring quality standards on the coaches used to provide the NEL services; and

(h) co-ordinating the provision of replacement coach services (if there are breakdowns) and onward connections to other NEL services (if there are delays).

Timetables and publicity

3.37. NEL publishes two timetables a year covering the winter (October to May) and summer (May to October) seasons. The summer season is busier, the most important months being July, August and September. Within the year, demand for coach services peaks at certain periods, the busiest times being Easter, Christmas and certain other public holidays. The basic method of communicating the range of NEL services is the timetable, which is distributed to all sales outlets. This is a substantial (1 inch thick) document distributed mainly to sales agents incorporating maps, places served, interchange tables, timetables and fares for standard, Airlink Rapide, London Rapide and leisure services. For each major town NEL publishes a `town leaflet' which sets out details of NEL services and fares to up to about 100 destinations which can be reached by NEL services from that town. NEL also distributes publicity material by direct mail and door-to-door deliveries.

3.38. Apart from NEL's own services, there are three peripheral local services which are included in the NEL timetable by arrangement with the independent operators who run these services and who set their own service schedule and fares. These services include London to Oxford, London to some Essex towns and a route in Lancashire. NEL told us that it did not operate these routes because of the relatively low incremental business or for other commercial reasons. Most of the tickets for these services are sold by the operator itself with NEL selling only a relatively small volume of tickets. NEL told us that the reason for including these details in its timetable was because the routes complemented or fed its own services and inclusion (in two instances at the operators' request) plugged a gap which would otherwise have occurred in its network.

Route planning

3.39. NEL is responsible for determining which routes should be operated, what the frequencies should be (on any given day of the week and at any time of year) and how the interlinking between routes should be effected. NEL's standard routes are supplemented during the summer and at certain other peak travelling times throughout the year. Each route will typically include a number of stops and the movement between any two scheduled termini is classified as a timetable journey. The configuration of timetable journeys completed by one vehicle during the course of a day is referred to as a `diagram'.

Monitoring of operations and quality control

3.40. NEL monitors each service as it is operated. In the event of breakdowns or delays a 24-hour control centre initiates action to solve the problem and bring the operation back on schedule. Most coaches are checked at pre-planned locations every day to ensure that they are presented in line with the contract specification. The performance of each operator (measured in terms of reliability, presentability, conformity with specification, internal and external cleanliness and other criteria) is monitored on a periodic basis and a `league table' of operators is produced for the purposes of assisting in the decision about which operators are to be preferred in future.

Coach operations

3.41. As previously stated, NEL contracts with individual coach operators which provide the coaches, staffed with a driver (and on Rapide services a hostess or steward), who are employed by the coach operator. The operator is also responsible for the maintenance of the coaches at its own depots. NEL does not have any maintenance depots of its own. Around 45 coach operators currently operate scheduled services under contract to NEL.

3.42. NEL's contract with a coach operator typically includes:

(a) agreement by the operator to provide a coach to operate over agreed routes, to a particular schedule (that is, a diagram-see paragraph 3.39). The coaches for a particular NEL route may be provided by more than one coach operator. A coach may operate as one NEL service on the outward journey and as a different NEL service, on a different route, on the return journey;

(b) details of the type, age and specification of vehicles to be used;

(c) a requirement that the coaches carry the NEL name and livery;

(d) a requirement that all costs of operating the coaches including salaries of the driver, hostess/steward and depot staff, uniforms, fuel, cleaning and maintenance costs be borne by the operator;

(e) a requirement that the operator's staff and vehicles comply with standards laid down by NEL. NEL issues a detailed Crew Manual and Operator's Manual which sets out the detailed specifications and quality standards to be met by coach operators; and

(f) a provision that payment by NEL to the operator be calculated by reference to the content of the diagrams (that is, route, speed, mileage and driver requirements). This results in an agreed price per day per diagram.

3.43. Contracts run for varying periods, generally between six months and five years, with notice periods for termination of, typically, two to three years.

Coach stations and pick-up points

3.44. NEL's services pick up passengers at a combination of coach and bus stations and roadside pick-up points. In most cases these pick-up locations are not owned or controlled by NEL. Coach and bus stations are usually owned by a local authority or another public transport operator. For example, London's VCS, which is NEL's central London hub, is owned by London Transport; Derby Coach Station is owned by Derby City Council; and Chesterfield Coach Station is owned by Stagecoach. At each coach station NEL makes arrangements with the coach station owner for access by NEL's services to the station at agreed times, for which a fee is payable. The fee is typically calculated by reference to the number of departures made by NEL coaches.

Ticket sales

3.45. Passengers wishing to travel with NEL can purchase a ticket through a variety of means:

(a) *Telesales*. Currently about 10 per cent of tickets by sales value are booked direct with NEL by telephone. NEL operates telesales centres at offices in Birmingham and Manchester which offer a ticket sales facility accessible at a local call rate from anywhere in the country.

(b) *Bus/coach stations*. NEL has its own retail sales operations at some bus and coach stations, which account for 13 per cent of ticket sales. Other operators and coach stations also sell NEL tickets.

(c) *Travel agents*.

(d) *Other retail outlets*. NEL tickets are available through a number of other retail outlets including Tourist Information Centres and some newsagents.

(e) *On-board sales*. Coach operators sell tickets to passengers on board their services under the terms of their operating agreement with NEL.

3.46. In total just over 2,000 sales agents (as categorized above) in the UK are issued with the complete NEL timetable. They can issue tickets manually and make seat reservations by telephoning NEL's central reservations operation, but in most cases they have a direct viewdata link to the NEL timetable, fares and reservations systems. NEL told us that it was currently developing a new system to automate ticket issuing and sales accounting. The system had been developed at a cost of £0.75 million to achieve improved transaction times, better accounting control, more accurate data capture, the creation of a marketing database and to reduce costs. It was currently used by NEL's telephone centre in Birmingham and by its own retail outlets. It was intended to offer it to a significant proportion of the NEL agency network. Existing reservations systems and manual issue of tickets will remain available for those agents who have not adopted the new system. NEG said that it believed this system did not materially disadvantage other coach operators since whether or not a computerized reservation system was of benefit depended on whether or not the operator was offering reserved seats or operating on a corridor network basis.

Financial performance

3.47. The trading summary of NEL for the last five years, 1991 to 1995, is set out in Table 3.6.

TABLE 3.6 **NEL: trading summary, 1991 to 1995**

£'000

	Years ended 31 December				
	1991	*1992*	*1993*	*1994*	*1995*
Turnover	96,089	93,639	91,785	97,702	97,615
Profit on ordinary activities before interest and taxation	6,822	3,269	4,043	5,795	5,200
Profit on ordinary activities before taxation	6,435	3,213	3,888	5,885	5,356
					per cent
Profit on ordinary activities before interest and taxation as a percentage of turnover	7.1	3.5	4.4	5.9	5.3

Source: NEL.

3.48. NEG told us that operating margins in 1991 benefited from the fare increases which were introduced by the incoming management team and initially increased operating profits. The subsequent fall in operating margins in 1992 and 1993 reflected the effects of the recession combined with the longer-term impact of the 1991 fare increases, which proved to be a disincentive for travellers and resulted in falling passenger journeys and revenue. The 1994 results were boosted in part by a general lowering of fares in late 1993, but more significantly by the rail dispute which helped to increase coach passenger numbers. Although falling slightly in 1995, operating margins were still buoyed by a growth in underlying passenger numbers (after allowing for the effects of the rail dispute on the 1994 results).

3.49. NEL's balance sheet position at 31 December for the last five years, 1991 to 1995, is set out in Table 3.7.

TABLE 3.7 **NEL: summarized balance sheets, 1991 to 1995**

£'000

	Years ended 31 December				
	1991	*1992*	*1993*	*1994*	*1995*
Fixed assets	2,408	2,540	2,836	3,725	5,345
Net current (liabilities) (excluding net borrowings)	(5,977)	(4,418)	(6,823)	(7,536)	(6,611)
Net operating (liabilities)	(3,569)	(1,878)	(3,987)	(3,811)	(1,266)
Investments	50	50	50	50	50
Net cash*	8,493	8,823	10,425	12,174	11,246
Provisions for liabilities and charges	(851)	(652)	(22)	(11)	(7)
Shareholders' funds	4,123	6,343	6,466	8,402	10,023

Source: NEL.

*Includes amounts owed to and by parent and fellow subsidiary undertakings.

3.50. The fact, noted earlier, that NEL owns few assets but contracts with other companies to provide the coach services it needs to run its network, accounts for there being net operating liabilities in all years.

Midland Main Line Limited

History and corporate structure

3.51. MML currently runs services on routes that in some cases have been in existence since 1839. In 1844 these routes formed part of the Midland Railway Company network. The Railways Act 1921 amalgamated virtually all the railways in Great Britain into four companies and these routes became part of the London Midland and Scottish Railway. In 1948 the company was nationalized first as part of the Railway Executive and from 1962 as part of BRB. In April 1992, what are now MML's InterCity train services became part of Midland Cross Country, a vertically integrated profit centre within BRB's InterCity division.

3.52. On 1 April 1994 the operation of certain passenger train services of Midland Cross Country became the responsibility of Midland Main Line, a division of BRB. Another operating division, Cross Country Trains, was formed from the rest of the Midland Cross Country profit centre. The undertaking of MML was transferred to Midland Main Line Limited on 1 April 1995. MML was one of 25 TOCs formed at this date.

3.53. A description of the structure established for the privatization of the railways industry is provided in Appendix 3.3.

MML operations

Passenger services

3.54. MML operates passenger rail services principally between South Yorkshire, the East Midlands and London. It operates InterCity passenger rail services on a common route from London St Pancras to Leicester which then splits north of Loughborough into two: one route to Sheffield via Derby, with limited additional services to Leeds, and one route to Nottingham. MML services stop at 20 stations located in seven counties and Greater London. Figure 3.1 illustrates the MML routes.

3.55. MML's services run over 333 route miles and carried passengers for 436 million passenger miles during the year ended 31 March 1996.

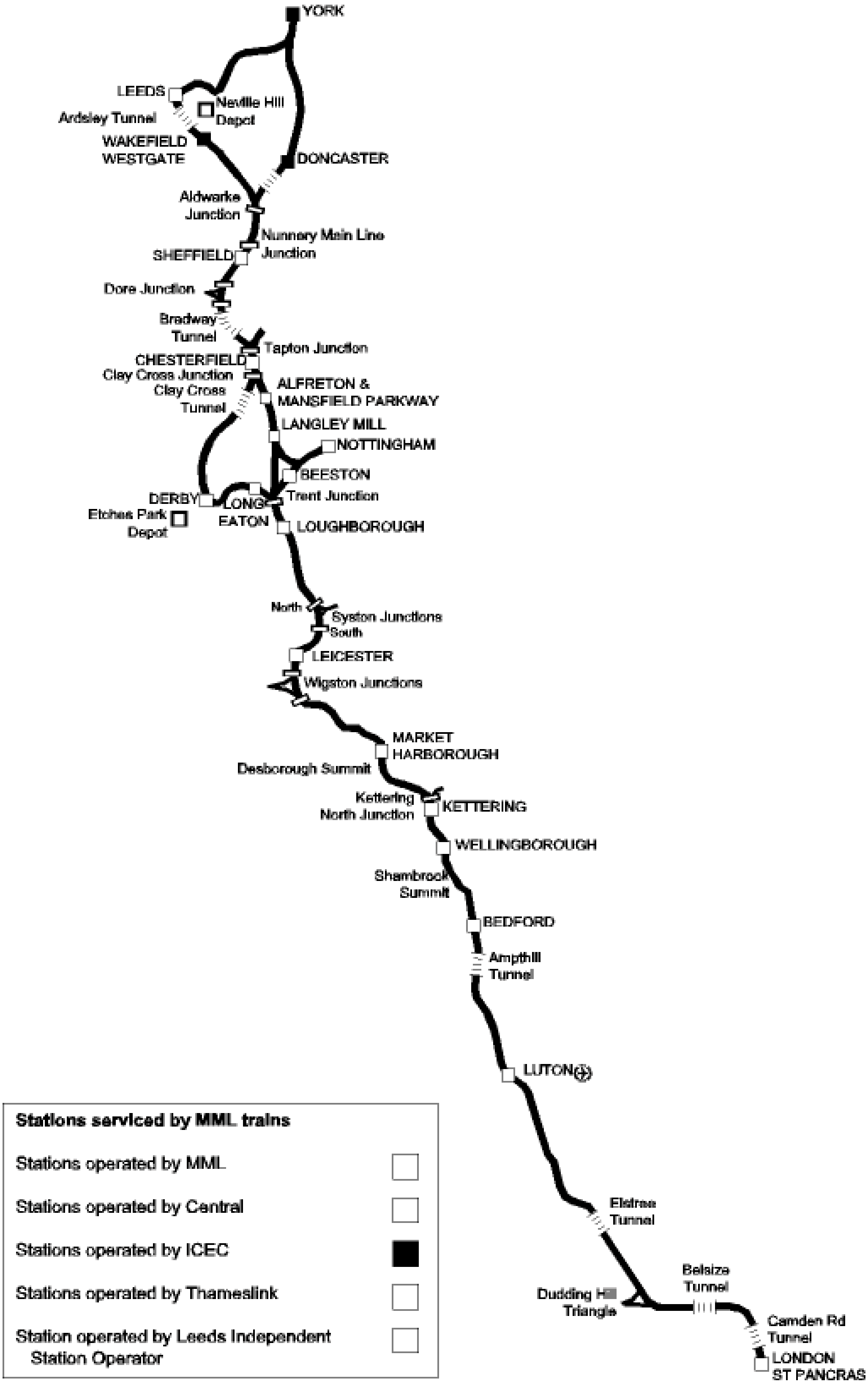
3.56. In the year to 31 March 1995 journeys to, from and through London accounted for 89 per cent of MML's passenger revenue. NEG was unable to provide the equivalent figure for the year to 31 March 1996. A significantly higher proportion of MML's passenger revenue is generated by customers whose outward journeys start in South Yorkshire or the East Midlands compared with those whose journeys start in London.

Stations

3.57. MML has responsibility for operating seven stations leased from Railtrack (Sheffield, Chesterfield, Derby, Leicester, Wellingborough, Market Harborough and Kettering). As the operator of its leased stations, MML is responsible for ticket retailing and for providing common amenities and services at these stations such as timetable and other passenger information, retail facilities, car parking, station cleaning and maintenance. In addition, MML has access rights to St Pancras station (owned by L&CR), to 11 stations owned by Railtrack and operated by other TOCs (including Nottingham operated by Central Railways), and to Leeds station which is both owned and operated by Railtrack. MML has a station operation agreement with L&CR to provide station services at St Pancras, such as information, customer services and cleaning. MML also leases and operates the Travel Centre at Nottingham.

FIGURE 3.1

Main features of MML core routes



Source: NEG.

Rolling stock

3.58. MML currently operates a passenger rolling stock fleet of 148 High Speed Train (HST) vehicles (comprising HST Class 43 Power Cars, MK III HST trailer and catering cars) to provide it with its weekday operational requirements. All of the rolling stock is leased from Porterbrook, one of the three ROSCOs. All trains are of a standard formation with the exception of those operated by the two Pullman HST sets. The standard formation sets offer 480 seats made up of 367 Standard and 113 First Class. Those operated in Pullman formation have 452 seats made up of 291 in Standard and 161 in First Class. This rolling stock provides MML with an availability of 13 train sets.

Depots

3.59. MML operates two depots which it leases from Railtrack. These are at Neville Hill, Leeds and Etches Park, Derby. Both depots undertake running maintenance, stabling, cleaning and refuelling. Neville Hill also undertakes heavy maintenance (ie planned maintenance to preserve the structural soundness of rolling stock). Regional Railways North East also has a depot operation at Neville Hill where it shares a number of facilities with MML. Railtrack has individual lease agreements with MML and Regional Railways North East for the depot facilities at Neville Hill.

3.60. Approximately 50 per cent of MML's depot activities associated with fleet maintenance (see below) are taken up by work for third parties. MML's principal customers, under its depot access agreements, are ICEC and Cross Country Trains at Neville Hill, and Cross Country Trains and Rail Express Systems Limited at Etches Park. MML also undertakes work for Railtrack at Etches Park.

Fleet maintenance

3.61. As mentioned in paragraph 3.58, MML leases its HST fleet from Porterbrook. Porterbrook, in turn, currently subcontracts some heavy maintenance work to MML. MML also performs heavy maintenance work on part of the Cross Country Trains fleet under contract to Porterbrook. The heavy maintenance contract with Porterbrook was signed on 14 March 1995 and will terminate on 31 March 1998. MML is able to tender for work in addition to the guaranteed volumes and for work from other ROSCOs. In the year ended 31 March 1995 MML also carried out heavy maintenance work for Angel Train Contracts Limited (Angel), one of the other ROSCOs, on trains operated by ICEC. [*Details omitted. See note on page iv.*]

3.62. Depot capacity and utilization is geared to overnight cleaning, fuelling and servicing requirements of sets in operational use during the day. Both Neville Hill and Etches Park have spare daytime capacity.

Financial performance

Years up to 31 March 1994

3.63. Because of reorganization within BRB there is very limited financial information available for the undertaking now carried on by MML for the years up to 31 March 1994. For the two financial years ended 31 March 1993 and 31 March 1994, the business which is now MML was part of a larger vertically-integrated profit centre known as Midland Cross Country. For accounting periods to 31 March 1994, there was no legal obligation to prepare statutory audited accounts for the individual operating units within BRB, and the audit of BRB was performed in order for an opinion to be expressed on the accounts as a whole. Limited financial information about revenues for the years to 31 March 1994 has been derived from the unaudited management accounts and other accounting records of Midland Cross Country and its predecessor organizations within BRB. As Midland Cross Country was a vertically-integrated profit centre of BRB's InterCity division up to 31 March 1994, operating both infrastructure and rolling stock, no meaningful cost information is available prior to this date. Table 3.8 shows key revenue data for the four years 1991 to 1994. This shows that, although passenger revenues (total passenger ticket revenue and revenue per passenger mile) have increased each year, the number of journeys and passenger miles travelled on the MML routes has steadily declined since 1991.

TABLE 3.8 **MML: key revenue data, 1991 to 1994**

	Years ended 31 March			
	1991	*1992*	*1993*	*1994*
Passenger ticket revenue* (£m)	55.8	56.8	56.3	58.7
Passenger journeys (m)	6.2	5.9	5.4	5.3
Passenger miles† (m)	515.5	485.7	455.1	437.2
Revenue per passenger journey (£)	9.00	9.63	10.43	11.08
Revenue per passenger mile† (£)	0.11	0.12	0.12	0.13

Source: NEG.

*Passenger revenue includes revenue from the sale of tickets and car parking.
†Passenger miles represents number of passengers multiplied by their journey lengths.

Years ended 31 March 1995 and 31 March 1996

3.64. Financial information for the year ended 31 March 1995 was derived from the audited BRB reporting forms on MML. We were told that these reporting forms had been audited to a materiality level consistent with the preparation of stand-alone accounts. The results for the year ended 31 March 1995 were affected by the RMT dispute with Railtrack during the period. A pro forma set of results was prepared as part of the franchising process. These were based on the audited results for the year to 31 March 1995 together with an estimate made by MML of the impact of the RMT dispute on the results. The impact was calculated by comparing the passenger revenue earned during the dispute with the equivalent period in the previous year. Table 3.9 summarizes MML's trading results for the years ended 31 March 1995 and 31 March 1996.

TABLE 3.9 **MML: summarized profit and loss account, 1995 and 1996**

£ million

	Audited results for the year ended 31.3.95	*Management estimate of impact of RMT dispute with Railtrack*	*Pro forma results for the year ended 31.3.95*	*Audited results for the year ended 31.3.96*
Turnover (excluding financial support)				
Passenger ticket revenue	58.5	3.4	61.9	63.1
Train catering revenue	2.3	0.1	2.4	2.5
Train maintenance revenue	23.8	0.2	24.0	23.7
Other	9.4	0.1	9.5	9.9
	94.0	3.8	97.8	99.2
Operating costs				
Staff costs	22.9	-	22.9	22.4
Fuel and material costs	21.3	0.1	21.4	20.7
Other intra-group purchases	10.0	-	10.0	10.5
Other managed costs	4.8	-	4.8	6.3
Privatization and redundancy costs	0.9	-	0.9	1.8
	59.9	0.1	60.0	61.7
Railtrack charges	42.8	2.2	45.0	32.7
ROSCO charges	16.6	-	16.6	16.6
Total costs	119.3	2.3	121.6	111.0
Operating profit/(loss) before financial support	(25.3)	1.5	(23.8)	(11.8)
Financial support*	28.2	-	28.2	16.8
Operating profit before interest and taxation	2.9	1.5	4.4	5.0
Interest (payable)	(0.6)	-	(0.6)	-
Operating profit before taxation	2.3	1.5	3.8	5.0

Source: NEG.

*For accounting purposes financial support payments are included within turnover in the audited accounts.

3.65. The reduction in operating loss before financial support of £12.0 million (from a loss of £23.8 million in 1995 to a loss of £11.8 million in 1996) is mainly attributable to reduced Railtrack charges which MML negotiated with effect from 1 April 1995. NEG told us that Railtrack charges are set in accordance with the Rail Regulator's policy which sets out their levels and structure. The formula for calculating the charges has a number of elements:

(a) a fixed annual charge;

(b) a variable usage charge, based on vehicle miles travelled; and

(c) adjustments to reflect additional costs or savings made by Railtrack as a result of changes in law, or dealings in property.

Charges are index linked at RPI minus 2 per cent a year. MML's track access agreement runs through to 27 April 2003 (the end date for a seven-year franchise) and is extendable for a further three years in the case of a ten-year franchise.

3.66. Table 3.10 summarizes MML's balance sheet at 31 March 1995 and 1996.

TABLE 3.10 **MML: summarized balance sheets, 1995 and 1996**

		£ million
	Year ended 31 March	
	1995	*1996*
Fixed assets	616	586
Net current (liabilities) (excluding net borrowings)	(5,322)	(726)
Net operating (liabilities)	(4,706)	(140)
Net cash*	6,977	7,840
Provisions for liabilities and charges	-	(307)
Shareholders' funds	2,271	7,393

Source: NEG.

*Includes amounts owed to and by parent and fellow subsidiary undertakings.

The merger situation

Award of franchise for MML

3.67. On 26 September 1995 the Franchising Director issued an ITT for the right under a franchise agreement to provide the passenger rail services then provided by MML. MML was at that time a subsidiary of BRB. The franchise was offered for a seven-year period but the Franchising Director indicated a willingness to consider bids for a longer term if it was `demonstrated that these offer significant value for money benefits'.

3.68. On 8 December 1995 NEG submitted an indicative bid for the MML franchise. NEG was notified on 11 January 1996, by the Office of Passenger Rail Franchising (OPRAF), that it was one of four parties that had been short-listed in the MML franchise tendering process and was invited to submit a binding tender for the franchise. On 1 March 1996 NEG submitted to OPRAF a binding Tender to Acquire the MML franchise. In the Tender to Acquire NEG set out:

(a) a proposal to acquire the franchise for a minimum period of seven years and also a proposal to acquire it for an alternative period of ten years. NEG's bid (described in paragraph 3.71 and following)

required financial support from the Franchising Director in the early years with NEG starting to make premium payments to the Franchising Director in the later years; and

(b) details of the way in which NEG proposed to operate the franchise and the enhancements to service that it was proposing to implement during the franchise term (described in paragraph 3.85).

3.69. NEG was told on 27 March 1996 that it was the preferred tenderer for the MML franchise. On 19 April 1996 NEG entered into the franchise agreement for a period of ten years with the Franchising Director and a number of related agreements including the share purchase agreement for MML. The ten-year franchise period is conditional on NEG placing orders for additional rolling stock for MML by October 1997 and operating enhanced levels of service from the start of the summer timetable in 1999.

3.70. In accordance with the franchise agreement NEG took over responsibility for the operation of the MML services on Sunday 28 April 1996.

Financial background to the merger

Acquisition price

3.71. For the four years immediately preceding the franchise, MML (and its predecessor undertakings) had operated at a loss (before financial support payments). When bidding for the franchise to run MML, NEG was effectively bidding for the amount of subsidy that it would need from the Franchising Director. Over the term of the franchise this subsidy turns into a payment that NEG will make to the Franchising Director. Table 3.11 shows the annual payments (in nominal prices) to or from the Franchising Director contained in NEG's ten-year bid for the franchise. In the franchise agreement annual payments to/from the Franchising Director are stated in real prices (arrived at by adjusting the bid prices for the assumed movement in the RPI which was part of the bid instructions). The franchise agreement provides for future payments to be adjusted to reflect movements in the actual RPI.

TABLE 3.11 **MML: franchise payments to and from the Franchising Director (in nominal prices)**

£ million

	1996/97	*1997/98*	*1998/99*	*1999/2000*	*2000/01*	*2001/02*	*2002/03*	*2003/04*	*2004/05*	*2005/06*	*Total*
Payments to/(from) Franchising Director	[*Figures omitted. See note on page iv.*]										

Source: NEG's tender to acquire MML.

3.72. As stated in paragraph 3.69, the franchise term of ten years is dependent on specific conditions. If these are not satisfied, the franchise reverts to a seven-year term. Table 3.12 shows the annual payments (in nominal prices) to or from the Franchising Director contained in NEG's bid for the seven-year franchise.

TABLE 3.12 **MML: seven-year franchise payments to and from the Franchising Director (in nominal prices)**

£ million

	1996/97	*1997/98*	*1998/99*	*1999/2000*	*2000/01*	*2001/02*	*2002/03*	*Total*
Payments to/(from) Franchising Director	[*Figures omitted. See note on page iv.*]							

Source: NEG's tender to acquire MML.

3.73. OPRAF received three other bids for the MML franchise. [

Details omitted. See note on page iv.

Details omitted. See note on page iv.

] In net present value terms all the bids result in a net payment by the Franchising Director to the franchisee over both the seven- and ten-year terms.

TABLE 3.13 **MML: net present cost of bids received for MML**

£ million

	Franchise term	
	Seven-year	*Ten-year*
[*Details omitted. See note on page iv.*]		

Source: OPRAF.

[†]

3.74. In evaluating the bids OPRAF told us that it had regard, first, to the level of subsidy required from the Franchising Director and, secondly, to the level of services promised by the bidder. OPRAF said that NEG's bid for the seven-year franchise was the lowest subsidy bid while guaranteeing to provide a high level of services. For the ten-year franchise, NEG's was still the lowest subsidy bid by a significant margin and provided further improvements in new rolling stock and increased services, for several MML stations, from once an hour or less to twice an hour.

Financial projections

3.75. NEG's bid for MML included a set of revenue and profit projections. A summary of the profit and loss projections is provided in Appendix 3.4. These projections forecast profits (after support payments) of £[†] million in 1997, the first year of the franchise, rising to £[†] million in 2006, the last year of the franchise.

3.76. NEG forecasts that annual revenues will increase in nominal terms by £[†] million, or [†] per cent (from £97.1 million[1] in 1996-the year immediately preceding privatization-to £[†] million in 2006-year 10 of the franchise). Most of this increase is planned to come from initiatives designed to improve passenger ticket revenues. Of the total forecast increase in annual revenues of £[†] million, passenger ticket revenues are forecast to contribute £[†] million (increasing from £62.6 million[1] in 1996 to £[†] million in 2006).

Passenger ticket revenues

3.77. Table 3.14 summarizes NEG's projections for passenger ticket revenues over the ten-year franchise. The figures for base revenue (ie MML's assumed ten-year revenues had franchising not taken place) and new initiatives designed to increase revenues are stated in real prices. The table separately identifies the inflation adjustment which deals with fare increases (on both the base case revenues and the new initiatives).

[1]Estimated 1996 results used by NEG in the forecasting process. 1996 results per audited accounts show total revenue of £99.2 million (excluding financial support) and passenger ticket revenue of £63.1 million.

†Details omitted. See note on page iv.

TABLE 3.14 **MML: total passenger ticket revenues over the ten-year franchise**

	Total contribution to revenue over the life of the franchise £m
Base revenues	[
Volume increases (based on exogenous growth)	
Volume increases (based on improved marketing and sales channels)	
Fares initiatives (off-peak deep discounting, eg group fares)	
Lost revenue from East Coast Main Line's response to deep discounting	
New services-new rail passengers generated by half-hourly services on southern section of MML and by speeding up of services to Leicester, Derby, Nottingham and Sheffield	
[*Details omitted. See note on page iv.*]	*
Other-increased revenue owing to improvements in on-board services, refurbished trains, station improvements and Kettering-Corby bus link	
Sub-total	
Inflation adjustment for increases in fare prices	
Projected total annual revenue contained in tender	]

Source: NEG.

3.78. Further details of the incremental annual revenues are provided in Appendix 3.5.

3.79. NEG projects exogenous volume growth (increasing from £[*] million[1] in 1997 to £[*] million[1] in 2006 and contributing £[*] million over the ten-year franchise) despite MML's recent history which has seen a trend of falling passenger journeys. It told us that it expected population growth and motorway congestion to result in increasing numbers of rail passengers over the franchise term.

3.80. NEG's strategy for increasing MML's revenue is based on the following key initiatives:

(a) discounting of off-peak fares, particularly for group travel. This initiative is planned to be contributing additional annual revenues of £[*] million[1] by 2000, with total contributions over the ten-year franchise of £[*] million;[1]

(b) introduction, in 1999, of a half-hourly service to MML's southern section stations and consequent speeding up of services to Leicester, Derby, Nottingham and Sheffield. This initiative is planned to:

(i) attract new rail passengers to MML (forecast to be contributing additional annual revenues of £[*] million[1] by 2001, with total contributions over the ten-year franchise of £[*] million[1]); and

(ii) attract passengers from the [*] (forecast to be contributing additional annual revenues of £[*] million[1]-net of projected response to competition-by 2001, with total contributions over the ten-year franchise of £[*] million[1]); and

(c) improvements to on-board services, refurbished trains, station improvements and a bus service to bring Corby residents to the MML station at Kettering are planned to contribute additional annual revenues of £[*] million[1] by 2000 (with total contributions over the ten-year franchise of £[*] million).[1]

3.81. NEG's forecasts include fare [*] per cent a year (with [*] in regulated fares being lower than this) based on assumed movement in the RPI. Annual inflation increases make up a sizeable part of

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[1]Figures stated in real prices.

*Details omitted. See note on page iv.

the increase in passenger revenues, rising from £[*] million in 1997 to £[*] million in 2006. Over the life of the ten-year franchise, these increases will amount in total to £[*] million.

Operating cost projections

3.82. NEG forecasts that the level of operating costs, as shown in Appendix 3.4, will remain largely static, increasing from £[*] million in the first year of the franchise to £[*] million in the last year of the franchise. Initially operating costs are projected to rise from £[*] million in 1996 to £[*] million in 1997, but then to fall by [*] per cent in 1998 and [*] per cent in 1999 due mainly to staff savings and to cost efficiency gains in the train maintenance business. The introduction of the new rail services, in 1999, adds [*] per cent to operating costs. This is because of higher track access charges (up £[*] million from the previous year) and train leasing costs (up £[*] million from the previous year but offset by returning certain existing HST stock-with an annual lease cost of £[*] million-to the lessor). For the remainder of the franchise, 2001 to 2006, operating costs are forecast to increase at around [*] per cent a year, reflecting inflationary increases. Train leasing and track access costs, which represent just under half the total operating costs, are largely fixed by contract throughout the term of the franchise.

Rights and obligations created by the franchise agreement

3.83. MML operates subject to a number of regulatory and contractual obligations resulting from the legislation under which the rail industry was privatized.

3.84. Appendix 3.3 sets out the key elements of the franchise agreement between the Franchising Director and all franchisees for the provision of passenger services by a TOC.

3.85. In the MML franchise agreement, NEG also provided a number of additional service features over and above those required as a minimum. As mentioned earlier, OPRAF told us that NEG's bid was selected because it was financially significantly more attractive than those of its competitors and offered a high level of service, and also because it was superior in the service enhancements offered. These are detailed in the Franchise Plan attached to the franchise agreement and, in outline, they are:

(a) a greater number of services to all destinations than the minimum required, running within a longer daytime span. The effect of this is that the pre-franchise level of services is broadly maintained;

(b) a refurbishment of all existing rolling stock, to be completed within two years of the franchise commencement date;

(c) the purchase or lease no later than in or around May 1999 of 12 additional two-car temperature-controlled diesel multiple units to enable the operation of a significantly enhanced level of service on certain routes (the ten-year franchising agreement is conditional on this commitment being delivered);

(d) to spend, or incur lease charges reflecting, £[*] million capital to provide improved facilities at all stations within the first three years of the franchise term;

(e) to undertake a feasibility study into the development of an East Midlands Parkway Station (to be sited between Loughborough and Trent Junction);

(f) to procure effective surveillance equipment such as closed circuit television cameras and install them at all stations and car parks together with lighting systems to render such equipment effective; to use reasonable endeavours to ensure that such cameras and recording equipment operate 24 hours a day, manned at all hours that the station is open. This to be done within 12 months of the franchise commencement date;

(g) to provide within three months of the commencement date a return bus or coach service from Corby to Kettering station to meet all trains which stop at Kettering station;

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*Figures omitted. See note on page iv.

(h) to provide on all HSTs one on-board staff member for every two occupied vehicles;

(i) to provide complimentary tea or coffee to all passengers; and

(j) the introduction for small groups of a deep discounted off-peak group return flat fare.

3.86. In common with all operators, MML is obliged to set out its own passenger charter in terms no less favourable than those required to be provided by BRB's passenger charter. Under its own charter MML is set a standard for punctuality of 90 per cent of trains (Monday to Saturday) arriving within ten minutes of the scheduled time set out in the passenger's timetable, and a standard reliability of 99 per cent of trains running. MML is required to provide compensation to holders of season tickets (for periods of one month or more) when the moving annual average for performance in respect of either reliability or punctuality in any four-weekly period falls below defined trigger levels (3 per cent for punctuality and 1 per cent for reliability). Additionally the charter provides extensions to season tickets where MML is unable to offer a train service on a particular day and no alternative transport is offered. It also provides *ex gratia* payments to holders of other tickets where there have been delays of over an hour.

The reference services

3.87. Our terms of reference refer to `the supply of public transport services between London and, respectively, Derby, Sheffield, Chesterfield, Nottingham and Leicester'. In this report we refer to these services as `the reference services', and we refer to coach services, which include the reference services but are not necessarily confined to them, as `relevant coach services'.

Profitability on the reference services

Reference coach services

3.88. NEG told us that the main coach services operated between the five specified places and central London by NEL were:

(a) *Service 440*: a daytime service from Derby and Leicester to Milton Keynes, Golders Green and London Victoria with some journeys starting in Manchester, Buxton, Burton and Heanor;

(b) *Service 450*: a daytime service from Mansfield via Nottingham to Milton Keynes, Golders Green and London Victoria with one journey starting in Retford and one in Alfreton; and

(c) *Service 560*: a daytime service from Barnsley via Sheffield and Chesterfield to Milton Keynes, Golders Green and London Victoria.

3.89. In addition, NEL operates:

(a) *Service 465*: a night-time service from Huddersfield and Leeds to London Victoria, calling at Sheffield, Nottingham and Leicester;

(b) *Service 564*: a daytime service from Halifax and Huddersfield to London Victoria with two journeys a day in summer (one in winter) calling at Sheffield and Chesterfield;

(c) *Service 230*: a mainly daytime service from Gatwick and Heathrow to Leicester and Nottingham, with most services continuing to Newcastle; and

(d) *Service 240:* a mainly daytime service from Gatwick and Heathrow to EMIA, Chesterfield and Sheffield, and then to Leeds and Bradford.

3.90. NEG told us that the only costs allocated to individual services are the payments made to the coach operators. No allocation is made of overheads to individual services. It said that the majority of overheads could be allocated, although certain allocations might not be very scientific in their approach. Although not part of its normal accounting procedures, NEG prepared an analysis of profitability, for the year ended 31 December 1995, as a special exercise. The analysis shows the results for each of the five services 440, 450, 560, 230 and 240 compared with all other services taken together, at both the gross margin and net trading profit level. NEG did not provide complete data about services 465 and 564. It said that these services operated with very limited frequency predominantly serving other point-to-point flows.

3.91. A summary of the analysis is given in Table 3.15.

3.92. The reference coach services (that is, the point-to-point journeys between the five specified places and London) are sections of the service routes above. Details of the revenues earned on the reference services are provided in Table 3.16.

TABLE 3.16 **NEL: revenues from the reference services, 1995**

	*£'000**
Service 440	[
Service 450	
Service 560	†
Service 230	
Service 240	]
Total	4,302

Source: NEL.

*Revenue between the five specified places and London only (that is, excluding revenue from passengers joining or leaving the coach between the five specified places and London).

3.93. Services 440 and 450 (covering Derby, Leicester and Nottingham to London services) operate at much higher trading profit margins ([†] per cent and [†] per cent respectively) than the rest of NEL's services ([†] per cent). The trading profit margin for the 560 service at [†] per cent (including the Sheffield/Chesterfield-London reference service) is just below that of all other NEL services combined. NEG told us that fares on the 560 service had been reduced in 1993/94 to stimulate demand on this route which NEG saw as having volume potential. NEG told us that the low margins on services 230 and 240 are due to the fact that airport services required frequent operation and in the early stages of development utilization levels are lower than average. This, together with the costs of an airport operation, results in the lower margins. In addition, on service 230 which extends to Newcastle there is limited demand on its northern section.

Reference rail services

3.94. We asked NEG to provide us with information about MML's rail service profitability (that is, revenues, direct costs and overheads). NEG told us that whilst revenues are allocated to individual flows, it did not as a matter of course allocate direct costs or overheads. Instead MML is treated as a single integrated activity. NEG argued that a significant proportion of MML's costs are fixed (for example, Railtrack charges) and cannot therefore be meaningfully allocated to specific flows of passengers.

3.95. We were provided with data about total passenger revenues and journeys. Table 3.17 shows the revenue per passenger journey and mile projected by NEG over the ten-year franchise. Data for 1995 and 1996 have been included for comparative purposes.

TABLE 3.15 **NEL: summarized analysis of sector profitability, 1995**

	Service 440		*Service 450*		*Service 560*		*Service 230*		*Service 240*		*All other services*	
	£'000	*%*	*£'000*	*%*	*£'000*	*%*	*£'000*	*%*	*£'000*	*%*	*£'000*	*%*
Total revenue*	1,483	100.0	1,346	100.0	1,089	100.0	[	*Figures omitted. See note on page iv.*				]
Total direct costs	[											
Gross margin												
Total overheads					*Figures omitted. See note on page iv.*							
Trading profit												
Passenger loading†												]

Source: NEL.

*NEL's direct income is recorded income from tickets used on coaches. In practice its actual income exceeds this figure owing to the loss of tickets, etc. This surplus income is called `pool add-back' and is allocated to routes according to their share of total income. Total revenue also includes sales of discount coach cards, holidays, and other miscellaneous income (also allocated to routes according to their share of total income).

†Passenger loading represents total passenger kilometres travelled (number of passengers multiplied by their journey distance) divided by total seat kilometres available (number of available seats multiplied by kilometres travelled).

TABLE 3.17 **MML: key revenue data, 1995 to 2006**

	1995	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
Passenger ticket revenue (£m)*	58.5	[										
Passenger journeys (m)	5.2											
Passenger miles (m)	415.4					*Figures omitted. See note on page iv.*						
Revenue per passenger journey (£)*	11.25											
Revenue per passenger mile (£)*	0.14											]

Source: NEG.

*Figures stated in nominal prices.

Competition law issues

3.96. The ITT advised interested parties to give consideration to the possible application of UK and EC competition law to their tender. NEG told us that it had satisfied itself that the transaction did not constitute a concentration with an EC dimension under the EC Merger Regulation (Council Regulation 4064/89) since the combined world-wide group turnovers of NEG and MML were substantially under the relevant threshold and because each of NEG and MML achieves more than two-thirds of its EU turnover in the UK.

3.97. Under section 66(3) of the Railways Act 1993, the acquisition of a passenger rail franchise is treated as the acquisition of control of an enterprise for the purposes of the Act. The gross assets transferred to NEG at completion were just over £15 million. The transaction was not therefore a merger situation qualifying for investigation under section 64(1)*(b)* of the Act. The application of the share of supply test under section 64(1)*(a)* of the Act is discussed in Chapter 2.

3.98. In view of the potential merger situation qualifying for investigation NEG had discussions with the OFT in early 1996 and offered to give undertakings about its conduct on key coach services which overlapped with MML's rail services should its bid be successful. Initially six point-to-point flows where coach and rail services overlapped were identified (though Loughborough-London was later excluded from any further consideration):

Sheffield (via Chesterfield)-London
Chesterfield-London
Derby-London
Nottingham-London
Leicester-London
Loughborough-London

3.99. [

Details omitted. See note on page iv.

]

3.100. Further discussions then took place between NEG and the OFT in March and April. (During this period, as noted earlier, NEG submitted its Tender to Acquire MML (1 March), was announced as preferred bidder by OPRAF (27 March), and was awarded the franchise (19 April).) In these discussions NEG emphasized its preference for behavioural undertakings rather than undertakings relating to divestment but indicated a willingness to explore all means to resolve the competition concerns. The behavioural undertakings offered were:

(a) not to increase prices on the coach services between the five places and central London other than in line with increases in the RPI, or alternatively no greater than increases on other parts of the NEL network;

(b) to keep quality standards on these coach services as high as elsewhere on the NEL network. It was proposed that quality standards would be judged in terms of age and quality of coaches, amenities on coaches and other matters referred to in existing NEL crew and operator manuals and quality assurance check lists; and

(c) not to increase APEX rail fares on the MML services between the five places and central London above increases in the RPI (recognizing that the Saver fare was linked to the RPI under the terms of the franchise agreement).

NEG also noted that predatory behaviour in relation to coach fares was likely to be constrained by the power of the DGFT to order a monopoly reference.

3.101. NEG also said that it remained willing to give serious consideration to the possibility of divestment should this prove necessary. However, NEG said that it felt divestment (in the sense of disposal of a business or a package of assets) was not feasible because it did not own any assets that could be transferred to the new operator and the routes at issue did not constitute a discrete business. Consequently divestment would in practice mean simply NEG withdrawing from the routes rather than transferring a business to a new operator. NEG also expressed concern about the damage to the existing level of service to coach passengers within the MML corridor [*Details omitted. See note on page iv.*] if it was forced to withdraw services on these routes. In these circumstances NEL felt that an undertaking to divest (or to withdraw its services) would not result in the benefits for the public interest which structural remedies normally provided.

3.102. NEG also reviewed the issues relating to the NEL network which divestment of certain services would raise. NEG felt it would be feasible:

- to include the new operator's timetable in the NEL timetable (so long as the new operator fitted in with the publication deadlines);

- to publicize the new operator's fares (subject to certain limitations); and

- for NEL agents to sell tickets for the new operator (subject to various mechanisms being put in place);

and to provide various other services so long as the new operator:

- paid a reasonable fee; and

- conformed to quality and service standards laid down by NEL since in NEG's opinion it was inevitable that consumers would regard NEL and the new operator as linked in some way and so there would be potential for NEL's reputation to be damaged if there were problems with the quality of the new operator's services.

3.103. NEG nevertheless said it was concerned that to provide structural divestment undertakings coupled with behavioural network access undertakings would have significant practical disadvantages and would not create a visibly independent competition, would require extensive monitoring by the OFT, would risk reducing the level and quality of coach services, [*Details omitted. See note on page iv.*].

3.104. The OFT for its part said that it was seeking an undertaking to divest a viable business likely to compete with NEG's rail services between the five places and London. It identified the four specific NEL daytime services together with an overnight service as described in paragraphs 3.88 and 3.89 (excluding services 230 and 240).

3.105. The OFT said that it did not envisage that the undertakings would include any requirement to co-ordinate services, nor that there needed to be any agreement on prices between NEL and the new operator. The OFT also did not regard it as reasonable for NEL to seek to impose quality standards or other interlinking arrangements highlighted by NEG.

3.106. In further discussions NEG confirmed its view that divestment of the routes to a new operator needed to be accompanied by safeguards about that operator's operational and safety standards if NEG was to be obliged to provide the support requested in respect of such operators' services. As a separate matter NEG raised the possibility of NEL simply withdrawing from the services leaving the way open for one or more newcomers to operate on a `corridor' basis without inclusion in the NEL network arrangements.

3.107. On 27 June 1996 the Secretary of State announced that, in accordance with the DGFT's advice, he intended to refer NEG's acquisition of MML to the MMC unless NEG gave suitable undertakings to remove the competition concerns arising from the acquisition. He agreed with the DGFT that structural and behavioural undertakings in lieu of reference, as outlined below, might be appropriate and sought third party views on them. NEG would be required to:

(a) withdraw from coach operations on point-to-point journeys between London and Derby, Leicester, Sheffield, Chesterfield and Nottingham;

(b) use its best endeavours to encourage new operators to run services on these routes;

(c) ensure that new operators have access to bus or coach stations or stands used for these journeys from which NEG has withdrawn;

(d) include details of the new operators' services in NEG's own printed timetables;

(e) allow sales of any new operators' tickets in NEG outlets and agents; and

(f) ensure that NEG's agents do nothing to discourage the use of the new operators' services.

3.108. NEG told us that the OFT made available to NEG a text of the proposed undertakings and discussions and clarifications took place in early July. On 17 July NEG notified the OFT that it continued to hold the view that the behavioural undertakings it had offered covered the areas of possible public concern and were more appropriate than the combination of structural and behavioural undertakings sought by the Secretary of State, to which it was not able to agree. NEG said that this would have amounted to NEG giving unconditional undertakings to provide various forms of assistance to any new operators requesting such support from NEG and, more importantly, irrespective of the quality and safety record of the operators concerned. NEG was concerned that agreeing to such undertakings would create very substantial operational difficulties and costs, potential liability and the risk of significant damage to NEG's operations as a result of consumers incorrectly assuming that NEG was in some way responsible for or endorsing the new operators' services.

3.109. The merger was referred to the MMC on 30 July 1996.